FOCUS ON THE ECONOMY

Diagnostics Yield Prescription for Recovery

by Hugh F. Kelly, CRE

Diagnosis and prescription are distinct operations in economics as in medicine. But they had better be well related, or the patient may be in for a rough time. The economy, like the human body, has marvelous natural recuperative powers. Intervention, therefore, is indicated only when and to the degree that the course of treatment will enhance the healing process that occurs in due time. Hippocrates, after all, enjoined physicians, "First, do no harm."

Economists, in their shorthand, write the equation for national output as GDP = C+I+G+(x-i). Translated, that means Gross Domestic Product is composed of Consumption, Business Investment, Government Spending, and the Balance of Trade. Diagnosing the economic ills that threw the nation into recession involves a look at these specific components to see where the fever began, and where the symptomatic chills are worse.

During the tremendous economic boom of the '90s, two staples of my talks around the country were the comments that "we will remember these as the 'good old days,'" and "inflation in the fundamental economy is not a problem; it is only in the stock market that we see 'too much money chasing too few goods.'" Undoubtedly, the United States will be challenged to approach the combination of robust GDP growth, low inflation, low unemployment, and substantial, sustained productivity gains that characterized the past decade. It is not impossible, though it will take a combination of skilled public policy planning and execution, sustained business management for long-term profit growth, and some luck on the world scene. I will deal with these topics in the 2002 series of columns for *Real Estate Issues*. Presently, I'd like simply to do some of the diagnostic work.

Where did the recession come from? Despite the decision of the National Bureau of Economic Research that the downturn started in March 2000, the causes of the recession need to be placed both before and after that date. The economy had been placed in fragile health by the overheated stock market (see *Exhibit 1:* "Trends in Stocks and Bonds"), epitomized by the NASDAQ bubble but spread throughout all the major indexes, including the broad-based S&P 500, which doubled in price between 1995 and 2000. While U.S. corporations were arguably much stronger at the end of the decade, there was no way that they were worth twice their 1995 value. So a full year before the "official" recession date, Wall Street was reeling in financial assets, and strapping the economy's strength. It's not for nothing that the S&P 500 is included in the Index of Leading Indicators.

As 2000 progressed, businesses started to pay stricter attention to inventory volumes (see *Exhibit 2:* "Inventory Correction – With a Vengeance"). Wholesalers

Exhibits 1 - 3

Exhibit 1

Trends in Stocks and Bonds

Sources: Standard & Poors; Lehman Brothers

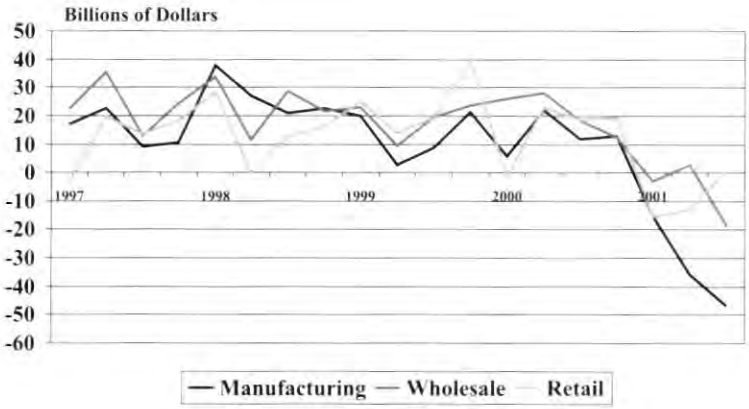
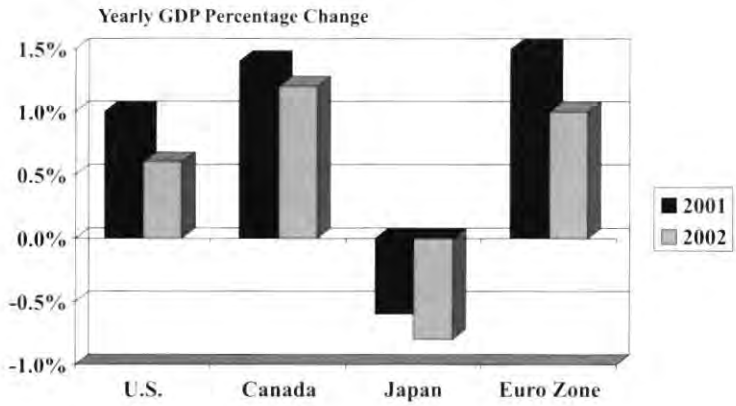


Exhibit 2

Inventory Correction–With a Vengeance

Exhibit 3

No Jump Start from Abroad



Source: *The Economist* Poll

led the trend from mid-2000 onward, and were joined by retailers and manufacturers as the year turned into 2001. What were the numbers? Immense. Inventories of all private businesses plummeted at a rate of $27.1 billion in the first quarter of 2001; $38.3 billion in the second quarter; and $61.9 billion in the third quarter.

So the "I" component of Gross Domestic Product was under considerable stress, even as the "G" component was producing "drag" in the form of federal budgetary surpluses. (When the government takes in more money than it spends, that counts as a negative in the GDP calculation.) And foreign trade (the [x-i] component) was producing disastrous figures. By 2000, our current account deficit was more than $450 billion; seven times the level of 1991 and three times as large as in 1995.

Nevertheless, through August of 2001 it was an open question whether the economy would slip into recession or if the Fed's aggressive rate reduction regime would engineer a third consecutive "soft landing" by Alan Greenspan. Consumer spending, the housing market, and continued expansion in the economy's services sector provided forward momentum for the nation. September 11 made the debate moot. With a severe contraction seen for the end of 2001, the dating committee of the National Bureau declared that the economy peaked in the previous March and we began concentrating on the depth and duration of this, the first recession of the 21st century. In this sense, the backdating of the recession to March was contingent upon unforeseeable (and previously unthinkable) events outside the parameters of forecasting models.

During economic contractions, of course, the critical concern is to locate the potential engines of recovery. For some of the indicators, hope can be discerned even in the first days of 2002. Stocks have recovered to the value levels prevailing prior to September 11, 2001, and typically perform well in the first year of an economic expansion. Inventories have been drawn down so drastically that the year 2002 will likely see this element of business investment turn positive by the spring. Fiscal policy interventions are superfluous to these trends: they are responding to their own market-oriented rhythms and to the monetary policy moves that have made the cost of capital exceptionally low.

Unfortunately, we can't expect much help from other major industrial nations, as can be seen in *Exhibit 3:* "No Jump Start from Abroad." Japan's troubles are actually expected to deepen in 2002. Mexico's GDP had contracted on a year-over-year basis by 1.6 percent as of third quarter 2001. Argentina's economy is in a shambles, with potential ripple effects elsewhere in Latin America and even in Spain. And while both Canada and Europe will outperform the U.S. in GDP growth this year, both will be slower than in 2001 and unlikely to be creating external market demand for American goods and services. This will have to be a bootstrapped recovery.

Thus we have our work cut out for ourselves in 2002. It would be exceptional if this recession were to persist into the summer, but the quality of the recovery and subsequent expansion should not be taken for granted. Done right, public and private economic decisions could put us back to the vigorous economic health we enjoyed during the '90s. Over-medication or inappropriate treatment could make for an extended convalescence and even have some nasty side effects that would last for years. But those are subjects for the coming editions of this journal. REI

ABOUT OUR FEATURED COLUMNIST

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